INVESTMENT COMPANY INSTITUTE

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Submitted electronically to grant.boyken@treasurer.ca.gov

Mr. Grant Boyken
California Secure Choice Retirement Savings Program
915 Capitol Mall, Room 110
Sacramento, CA 95814
Attn: Secure Choice RFI #13-01

Re: STO RFI #13-01 – SB 1234/California Secure Choice Retirement Savings Program

Dear Mr. Boyken:

The Investment Company Institute[1] is pleased to provide this response to the Request for Information issued by the California Secure Choice Retirement Savings Investment Board (Board) with respect to the California Secure Choice Retirement Savings Program (Program). The Program—a state-run retirement plan for private-sector workers in California—is under consideration by the Board, pursuant to legislation SB 1234 (the California Secure Choice Retirement Savings Trust Act, or "the Act") enacted in 2012. The Institute strongly supports efforts to promote retirement security for American workers and appreciates the interest of the legislature in ensuring that California residents have sufficient resources for retirement. Americans currently have $20.9 trillion saved for retirement, with more than half of that amount in defined contribution (DC) plans and individual retirement accounts (IRAs).[2] About half of DC plan and IRA assets are invested in mutual funds, which makes the mutual fund community especially attuned to the needs of retirement savers. The Institute has 32 member companies located in California employing approximately 13,333 people in the state, with

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.7 trillion and serve more than 90 million shareholders.

[2] *See* Table 1 in Investment Company Institute, "The U.S. Retirement Market, Second Quarter 2013" (Sep. 2013); available at www.ici.org/info/ret_13_q2_data.xls.

$2.8 trillion in assets under management.[3] Many of these companies provide investments and other services to retirement plans and individual retirement savers in California.

The Program outlined in SB 1234 would require all employers in California with five or more employees to automatically enroll employees into “a payroll deposit retirement savings arrangement” if the employer does not offer an employer-sponsored retirement plan or automatic enrollment payroll deduction IRA. It appears that contributions to accounts under the Program (intended to be treated as IRAs) would be invested collectively on behalf of Program participants, with a stated rate of interest allocated to accounts each year. The Act directs the Board to conduct a study to assess the feasibility of implementing the Program as outlined in the legislation. In order to implement the Program (which would require subsequent authorizing legislation pursuant to SB 923), the Board must find, among other things, that the Program will be self-sustaining, that the accounts will qualify for the favorable federal income tax treatment accorded to IRAs under the Internal Revenue Code (the Code), and that the Program is not an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA).

The gap in retirement plan coverage that motivated the legislation is more perceived than real. The statistic that only 50 percent of private-sector workers are covered by an employer-sponsored plan is misleading because it vastly underestimates the share of today’s workers who will reach retirement having accrued retirement benefits. Younger workers and lower-income workers are much less likely to work for an employer that sponsors a retirement plan, and much less likely to participate in a plan if one is offered.[4] But young workers do not remain young, and many lower-paid workers increase their earnings during their career. If one limits the analysis to those workers most likely to be focused on saving for retirement—workers aged 30 or older with at least moderate levels of earnings, and all but the lowest-earning workers aged 45 or older—the data show that 69 percent work for an employer that

[3] Investment Company Institute, California Profile (Spring 2011); available at www.ici.org/pdf/industry_stats_california.pdf.

[4] In household survey data, younger and lower-income households are less likely to say they are saving primarily for retirement. These households are focused on other savings priorities, such as paying off student loans, saving for a house, raising a family, or simply building up cash to meet unexpected needs. These preferences are consistent with economic models of rational behavior, which predict that individuals rationally delay saving for retirement until later in their working careers (usually at some point after age 40), when they typically earn more. These models show that this provides individuals with ample time to set aside resources for retirement. Further, retirement plan accumulations are used to supplement Social Security benefits in retirement. Because Social Security benefits replace a higher percentage of pre-retirement earnings for individuals with low lifetime earnings, lower earners are less likely to desire to save retirement at any given age. For a discussion of the reasons workers desire, and firm offer, retirement benefits, *see* Peter Brady and Michael Bogdan, “Who Gets Retirement Plans and Why, 2012,” *ICI Research Perspective* 19, no. 6 (October 2013); available at www.ici.org/pdf/per19-06.pdf.

sponsors a plan, while 74 percent have access to a retirement plan through either their own employer or their spouse's employer.[5] Instead of focusing on the share of workers with coverage, a better measure is the share of workers who have accumulated retirement resources by the time they retire. Among working households aged 55 to 64 in 2010, 81 percent had defined benefit (DB) plan benefits, DC plan accounts, or IRAs.[6]

While increasing coverage levels for private-sector workers in California is a worthy goal, we believe having the state run a private-sector retirement plan as contemplated by SB 1234 would bring significant cost and administrative burden to the state and its taxpayers. In addition, the state would directly compete with businesses in the state that already provide retirement plan products and services to employers and workers in California. These important considerations aside, our response focuses primarily on legal issues raised by the Program as outlined in SB 1234, under the Code, ERISA, and federal securities laws.

In an attempt to avoid the significant responsibilities associated with ERISA coverage,[7] the Act characterizes the Program accounts as IRAs. Question 18 of the RFI asks "What approach would you recommend to demonstrate the Program is not subject to ERISA and that Secure Choice accounts would qualify for favorable federal income tax treatment generally granted to IRAs?" As an initial matter, such demonstrations would require opinions or rulings from the Department of Labor (DOL) and Internal Revenue Service (IRS), the federal agencies charged with administering ERISA and the Code. In any case, we question whether the accounts would be treated as IRAs under the Code and,

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[5] *See* Brady and Bogdan (2013), *supra* note 4.

[6] *See* Peter Brady, Kimberly Burham, and Sarah Holden, *The Success of the U.S. Retirement System* (December 2012), Washington, DC: Investment Company Institute; available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

[7] Ironically, such responsibilities are intended to protect participants in retirement plans. ERISA protects the assets of millions of Americans so that funds placed in retirement plans during their working lives will be there when they retire. Among other things, ERISA requires plans to provide participants with information about the plan, including important information about plan features, fees and, as applicable, funding. The law also specifies when an employee must be allowed to become a participant, how long they have to work before they have a non-forfeitable interest in their pension, how long a participant can be away from their job before it might affect their benefit, and whether their spouse has a right to part of their pension in the event of their death. Perhaps most relevant here, ERISA requires accountability of plan fiduciaries who may be held responsible for restoring losses to the plan if their failure to follow prescribed principles of conduct cause the participants to suffer losses to their accounts.

even if they were treated as IRAs, we do not agree with the notion that the Program would not be subject to ERISA.[8]

I. Application of the Internal Revenue Code

Although the Act characterizes the payroll deposit retirement savings arrangements established under the Program as "IRAs" or "individual retirement accounts," which are described in section 408 of the Code, the accounts do not function like ordinary IRAs.[9] In an IRA, the account owner's balance consists of contributions made to the account and reflects any investment earnings or losses with respect to the individual's contributions. Under the Program, however, the account will not reflect the actual earnings or losses experienced by the individual's contributions, but instead will be credited with a stated rate of interest determined by the Board each year. This formulaic benefit is akin to a cash balance plan, which is considered a defined benefit pension plan under the Code and ERISA, normally subject to minimum funding standards and PBGC insurance premiums. Individual retirement accounts, on the other hand, are akin to defined contribution arrangements, which, under both the Code and ERISA, are defined as individual accounts with benefits based solely on the amount contributed and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such account.[10] We therefore question, as others have, whether an account that is not an individual retirement annuity, could be structured this way and still be accorded the favorable federal tax treatment applicable to IRAs under the Code.[11]

II. Application of ERISA

Assuming for argument's sake that the Program accounts would qualify as IRAs under the Code, the next legal question is whether ERISA governs the Program. Generally, payroll deduction IRA programs allow employees to make regular contributions to a retirement savings account without requiring a "full-blown" tax-qualified plan (*e.g.*, a 401(k) plan), and without triggering employer fiduciary responsibility under ERISA. DOL regulations under ERISA provide for a safe harbor under

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[8] It is worth noting that the Program would not be exempt from ERISA as a "governmental plan" described under section 3(32) of ERISA. Governmental plans must be established or maintained by a government for its employees. Because the Program would cover private-sector employees, it would not be exempt from ERISA as a governmental plan.

[9] We note that the Act does not appear to contemplate the use of individual retirement annuities, which are also commonly known as "IRAs" and are described in Code section 408. The Act uses the terms "account," "individual account," and "individual retirement account" when referring to the participant's interest in the Program.

[10] ERISA § 3(34) and Code § 414(i).

[11] *See* Edward A. Zelinsky, *California Dreaming: The California Secure Choice Retirement Savings Trust Act*, 19 Conn. Ins. L. J. (Apr. 2013); available at: http://ssrn.com/abstract=2258630.

which a payroll deduction IRA program will not be considered an employee benefit plan if (1) no contributions are made by the employer; (2) participation is completely voluntary for employees; (3) the sole involvement of the employer is to permit the sponsor to publicize the program to employees (without endorsement by the employer), to collect contributions through payroll deductions and to remit them to the sponsor; and (4) the employer receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions.[12] A 1999 DOL interpretive bulletin further clarifies the steps that employers may take without "endorsing" the program, including limiting the number of IRA sponsors offered under the program. An employer cannot take advantage of the safe harbor, however, if it exercises any influence over the investments made or permitted by the IRA sponsor. [13]

Although DOL has not directly addressed the question of whether an *automatic enrollment* payroll deduction IRA program would be subject to ERISA, it is likely that the automatic enrollment of employees would be deemed to exceed the limits of the safe harbor and result in ERISA coverage. At least two prongs of the safe harbor could be implicated by automatic enrollment—(1) that participation is completely voluntary and (2) that the employer does not endorse the IRA provider. The decision to automatically enroll employees into a plan typically is viewed as a discretionary plan design determination and involves fiduciary-type decision-making, such as selecting a default investment.[14] Although the employers in this case would be required by state law to automatically enroll their employees into the arrangement, that factor alone should not impact whether or not ERISA applies. ERISA's purpose is to protect the benefits of private-sector workers and we see no justifiable reason to deny these fiduciary protections to workers in one state. In addition, as explained below, the state (as opposed to the employer) could be determined to be the ERISA fiduciary with respect to the Program.

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[12] 29 C.F.R. § 2510.3-2(d).

[13] 29 C.F.R. § 2509.99-1.

[14] Non-profit employer 403(b) plans are eligible for a similar safe harbor from ERISA coverage under 29 C.F.R. § 2510.3-2(f). In this analogous context, it is generally accepted that an automatic enrollment feature would not be permitted under the DOL safe harbor. *See* Current Challenges and Best Practices for ERISA Compliance for 403(b) Plan Sponsors, ERISA Advisory Council Report, November 9, 2011; available at www.dol.gov/ebsa/publications/2011ACreport1.html. ("The Council also considered, but is not recommending, that DOL permit the inclusion of an automatic enrollment feature within the context of an ERISA safe harbor 403(b) plan. The majority of Council members concluded that automatic enrollment would require actions typically performed by a plan sponsor/fiduciary (e.g., designation of a default investment alternative), and consequently, an automatic enrollment option in the plan may not be viewed as voluntary even in light of the participant's right to opt out of the automatic contributions.")

In addition to requiring automatic enrollment, SB 1234 clearly contemplates the state playing a role in the selection of the investments available under the Program. The Board would determine who will manage the investments of the trust, and could select the state treasurer, the manager of the Public Employees' Retirement System, and/or a private money manager. It does not appear that individual participants would be able to direct their own investments among a menu of options. As noted above, an employer wishing to avoid ERISA coverage of a payroll deduction IRA program cannot attempt to influence the financial institution's selection of investment options. Again, the fact that the state instead of the employer is acting in this capacity, should not lead to a different result in terms of ERISA coverage in general. It may be that the state (as opposed to the employer) would be determined to be the ERISA fiduciary with respect to the Program.

Alternatively, another potential basis for concluding that the Program should be subject to ERISA relates back to the defined benefit-type formula contemplated by SB 1234. Although the Act technically would not require employer contributions to the accounts, one could argue that the stated interest credits are functionally equivalent to employer contributions—which are prohibited under the DOL's safe harbor regulation for payroll deduction IRAs. The Board essentially would have discretionary control over all investment gains earned on the accounts and would determine whether and when to allocate those amounts to participants, much like an employer sponsor of a cash balance plan. Moreover, the formula for determining participant account balances raises the same potential for underfunding that implicates ERISA's minimum funding standards and PBGC insurance. Although the Act contemplates the Board procuring private insurance to ensure against any funding shortfalls, we believe the same concerns that led to the enactment of ERISA to protect private sector benefit programs are applicable here, especially since the Act disclaims any state liability for benefits promised under the Program. In the event that problems arise, participants under this Program would very likely have no recourse against any responsible party if ERISA did not apply.

Ultimately, if a payroll deduction IRA program established by the state fell under ERISA, the fiduciary and other ERISA responsibilities would apply to the state and/or the employers participating in the Program, as discussed below. Although SB 1234 provides that the Board will not implement the Program if it is determined to be an employee benefit plan under ERISA, we believe it is important to review the significant obligations imposed under ERISA in case it is later determined (for example, by a court) that the Program is covered by ERISA. In addition, any state involvement in the employee benefit plan area raises potential federal preemption issues that could render the arrangement invalid.[15]

[15] Section 514 of ERISA generally provides that Title I of ERISA supersedes any state laws insofar as they relate to any employee benefit plan described in section 4(a) of ERISA. The exemption for governmental plans would not apply here

A. State as ERISA Fiduciary

A state sponsoring a retirement plan for private-sector workers likely would become a fiduciary under ERISA, under a functional analysis of fiduciary status.[16] If the state and/or its employees select investments under the Program, then the state and/or its employees could trigger fiduciary responsibilities by exercising "authority or control respecting management or disposition" of the plan's assets.[17] Although section 404(c) of ERISA provides protection from liability resulting from a plan participant's exercise of control over the assets in his account (which would not be the case here), the DOL takes the position that fiduciaries retain the responsibility to monitor the continued appropriateness of the investments available to participants.[18] A fiduciary that breaches its responsibilities under ERISA is personally liable to make good to the plan any losses to the plan resulting from the breach.[19] In addition, the Secretary of Labor may assess civil penalties in the case of a fiduciary breach.[20]

There are other implications associated with becoming an ERISA fiduciary to consider, including prohibited transactions and bonding requirements. If the state or its employees serve as fiduciaries under ERISA, they must ensure that the Program does not enter into prohibited transactions (*i.e.*, plans cannot enter into transactions with fiduciaries and other "parties in interest," including employers, service providers and related entities).[21] If a prohibited transaction occurs, the responsible fiduciary will have violated its fiduciary duty under ERISA and the "disqualified person" may be assessed an excise tax under the Code based on the amount involved.[22] If the Program covers

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because the Program would cover private-sector employees. It is possible that an interested party, such as an employer within the state that becomes subject to the Act's mandate, could bring a legal challenge against the Act on ERISA preemption grounds.

[16] Under section 3(21)(A) of ERISA, a fiduciary is a "person," which includes a number of different entities under the definition in section 3(9), but does not specifically mention government entities. Courts have considered ERISA fiduciary claims against government entities without specifically addressing whether a governmental entity is a "person" under ERISA. *See Coleman v. Pension Benefit Guaranty Corporation*, 2005 U.S. Dist. LEXIS 45021 (D.D.C. 2005), *aff'd*, 469 F.3d 1061 (D.C. Cir. 2006); *Plummer v. Consolidated City of Indianapolis*, 2004 U.S. Dist. LEXIS 20251 (S.D. Ind. 2004); *Boivin v. US Airway*s, Inc., 297 F. Supp. 2d 110 (D.D.C. 2003).

[17] ERISA § 3(21)(A)(i).

[18] 29 C.F.R. § 2550.404c-1(d)(2)(iv); 57 Fed. Reg. 46906, 46924 n. 27.

[19] ERISA § 409.

[20] ERISA § 502(*l*).

[21] ERISA §§ 3(14) and 406.

[22] Code § 4975.

hundreds or thousands of employers, avoiding prohibited transactions in the course of administering the Program may be difficult.

Section 412 of ERISA requires plan fiduciaries and others who "handle" plan assets to be bonded. The bonding requirement may apply even if the entity's activities do not constitute fiduciary duties under ERISA. "Handling" of assets occurs "whenever [a person's] duties or activities with respect to given funds or other property are such that there is a risk that such funds or other property could be lost in the event of fraud or dishonesty on the part of such person, acting either alone or in collusion with others."[23] In the event that state employees had access to the assets of employees who participate in the Program, and such risks were present, ERISA bonding would be required.

Although it is possible that potential fiduciary and prohibited transaction liability on the part of a state may be limited by the Eleventh Amendment and the concept of sovereign immunity, we question whether denying Program participants the fiduciary protections of ERISA would benefit private-sector workers in the state. In our view, to essentially give workers participating in the Program no recourse to hold any party responsible for the decisions made and actions taken with respect to their retirement savings would be unfathomable.

B. Other Duties Under ERISA

In addition to the fiduciary liability considerations discussed above, establishing an ERISA-covered plan requires a number of administrative actions. For example, ERISA requires the filing of an annual report to the IRS and DOL (Form 5500) and various disclosures to participants, including benefit statements, summary plan descriptions, summary annual reports, and summaries of material modifications.[24] The plan's trustee must make sure that participant deferrals actually are deposited in the plan in a timely manner and collect any delinquent contributions.[25] ERISA also requires plans to follow a specific process for reviewing participant and beneficiary claims, including providing notice of any claim denial, as well as the opportunity for a "full and fair review" of any such denial.[26]

[23] 29 C.F.R. § 2580.412-6(a)(1).

[24] *See* ERISA §§ 101 through 105.

[25] *See* DOL Field Assistance Bulletin No. 2008-01.

[26] *See* ERISA § 503 and 29 C.F.R. §2560.503-1.

C. Application to Participating Employers

Assuming the Program would be subject to ERISA, as discussed above, it is likely that the DOL would view the Program not as a single employee benefit plan, but rather as a collection of individually-sponsored plans, each of which would have to separately comply with the applicable obligations under ERISA described earlier. An employee pension benefit plan under section 3(2) of ERISA must be established or maintained by an "employer" as defined in ERISA section 3(5) (including a group or association of employers), an "employee organization" as defined in ERISA section 3(4), or both. Prior DOL guidance has recognized that a single "multiple employer plan" may exist where a cognizable or bona fide group or association of employers, acting in the interest of its employer members, establishes a benefit program for the employees of member employers and exercises control over various administrative functions on behalf of those members.[27] But when several unrelated employers merely execute identical trust agreements or other similar documents to provide benefits, in the absence of any genuine organizational relationship between the employers (such as a common trade association), DOL has concluded that no employer group or association exists for these purposes.[28] Courts and the Department have held that, in order to be considered an employee benefit plan, the entity maintaining the employee benefit plan must be tied to the employees or contributing employers by genuine economic or representational interests unrelated to the provision of benefits.[29]

More recently, in Advisory Opinions 2012-03A and 2012-04A, DOL concluded in both instances that a plan intended to be a multiple employer plan would not constitute a single multiple employer plan under ERISA, but rather a collection of separate unrelated plans with similar or identical plan documents.[30] DOL found that, in both factual situations, the company "sponsoring" the plan would not qualify as an employer (or an employee organization) with respect to the majority of the participating employees. In both of these situations, the relevant employers (including the respective

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[27] *See* Advisory Opinions 2003-17A and 2001-04A.

[28] *Id.*

[29] *MDPhysicians & Associates, Inc. v. State Bd. Ins.*, 957 F.2d 178, 185 (5th Cir.), *cert. denied*, 506 U.S. 861 (1992), quoting *Wisconsin Educ. Assoc. Ins. Trust v. Iowa State Bd.*, 804 F.2d 1059, 1063 (8th Cir. 1986); Advisory Opinions 94-07A and 80-42A.

[30] In Advisory Opinion 2012-03A, a firm proposed to take over abandoned individual account plans and merge them into its own ongoing individual account plan, which would cover its own employees in addition to participants in the formerly separate and unrelated abandoned plans. Although participants in the abandoned plans merged with the new plan could elect to roll over their accounts into an IRA or take immediate distributions, the proposed program also would allow these participants to maintain their assets in the ongoing merged plan. The facts in Advisory Opinion 2012-04A differ in that the "sponsor" of the arrangement purported to maintain a multiple employer plan covering its own employees and the employees of more than 500 unrelated active employers affirmatively adopting the plan as "co-sponsors."

entities sponsoring the arrangements who DOL characterized as more like service providers to the plans) had no apparent connection to each other beyond the benefit plan itself.

Applying the same analysis to the Program, DOL could conclude that there would not be a single multiple employer plan under ERISA, but rather an arrangement under which each participating employer establishes and maintains a separate plan for its own employees. The participating employers would have no connection to each other beyond doing business in California, and no connection to the state "sponsor" of the Program beyond being located within its jurisdiction. (Moreover, the state obviously would not be an "employer" or "employee organization" with respect to the covered employees.) The characterization of the arrangements as IRAs instead of plans likely would not change this analysis because, as explained earlier, the arrangements should be considered employee benefit plans under ERISA due to the Program's automatic enrollment feature.

The treatment of each participating employer as maintaining a separate ERISA plan would significantly add to the costs and burdens associated with the Program and require allocation of responsibilities between the state and participating employers. It is possible that both the state and the participating employers would be considered fiduciaries under ERISA. As DOL noted in Advisory Opinion 2012-04A:

> [P]ersons who operate the arrangement [i.e., the plan provider] would be subject to the fiduciary provisions of Title I to the extent they have control over plan assets or have discretionary control over the administration or management of the participating employers' separate plans. They would also be subject to the prohibited transaction provisions in ERISA section 406 to the extent they are "parties in interest" within the meaning of ERISA section 3(14) either as service providers to the separate employer plans or otherwise. Similarly, each employer sponsor of a plan that participates in the arrangement will be subject to ERISA's fiduciary provisions. *See* FAB 2002-03 (in selecting a service provider, plan fiduciaries must, consistent with the requirements of section 404(a), act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan).

D. Other State Proposals

Several other states have considered proposals to establish state-run plans for private-sector workers, whether 401(k), SIMPLE IRA, or other IRA-based arrangements, under the assumption that the state would have greater bargaining power and expertise, based upon its size and experience in providing retirement benefits for state employees, than the average private employer.[31] The proposals presume that small private-sector employers would benefit from economies of scale under a state-wide program. Given the substantial costs that would be involved in establishing and administering a retirement plan for private-sector workers, including compliance with ERISA, it is not surprising that to date, no state has implemented a state-run plan.

III. Application of the Federal Securities Laws

Another important consideration in assessing the costs of implementing the Program is the application of the federal securities laws and the regulations thereunder. The concept of a pooled investment vehicle to provide individual investors with diversification, professional management and economies of scale is not new. Congress acknowledged the benefits of those vehicles and focused on certain risks to investors when it enacted the Investment Company Act of 1940 (1940 Act), which regulates the business and operations of "investment companies," including mutual funds, closed-end funds, exchange-traded funds and unit investment trusts. That law provides important investor protections, making investment companies the most stringently regulated pooled investment product available.[32]

Below we explain why the pooled investment vehicle created by the Program (the Trust) would likely meet one or more of the definitions of an "investment company" under the 1940 Act (and why no exemption from registration and regulation is likely available). We also generally explain how the Program may implicate the Investment Advisers Act of 1940 (Advisers Act). We then explain some of the ramifications to the Trust of the application of the 1940 Act.

A. The Trust May Implicate Investment Company Regulation

The 1940 Act contains broad definitions of the term "investment company" that are likely implicated by the Trust.[33] Entities meeting the definition of an "investment company" must either

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[31] In addition to California, Connecticut, Maryland, Massachusetts, Michigan, Vermont, and Washington are among the states that have considered establishing some form of state-run plan for private-sector workers.

[32] The 1940 Act seeks to prevent self-dealing by managers, inequitable or discriminatory treatment of shareholders, misleading or fraudulent methods of pricing or valuation, changes to investment objectives without shareholder consent, excessive leveraging, and inadequate or inaccurate disclosure. *See, e.g., Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, U.S. Securities and Exchange Commission (May 1992); *see also* section 1(b) of the 1940 Act (specifically identifying the concerns that are presented by pooled investment vehicles).

[33] Congress defined the term "investment company" very broadly in the 1940 Act in order to further the purposes of the 1940 Act, which are set forth in section 1(b) thereof.

register with and be regulated by the Securities and Exchange Commission (SEC) as such, or seek an exemption from registration.

The question of whether the Trust implicates the 1940 Act entails a three-pronged analysis: (1) whether a security will be issued in connection with the Program; (2) the identification of the particular issuer of the security; and (3) the evaluation of whether the assets and the business of the issuer are those of an investment company. The Trust may meet each prong. First, it is likely that the interests of the employee participants in the Trust would be deemed to be securities under the federal securities laws.[34] Second, the issuer of the securities would appear to be the Trust.[35] Third, the Trust would appear to hold assets and engage in the business of an investment company.

In particular, the 1940 Act defines an "investment company" to include: any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire "investment securities" having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis (40 percent test).[36] The 1940 Act also defines the term to include: any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.[37] The collective investment of the eligible employees' payroll contributions in the Trust appears to directly implicate those definitions.

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[34] *See* sections 2(a)(36) of the 1940 Act and 2(a)(1) of the Securities Act of 1933 (1933 Act), both of which define the term "security." *See also* 1933 Act Release No. 6188 (Feb. 1, 1980) (discussing when employee interests in an employee benefit plan are securities under the 1933 Act). Insofar as the Program and the Trust would entail a public offering of securities, the 1933 Act requires that public offering to be registered with the SEC.

[35] *See* section 2(a)(22) of the 1940 Act, which defines the term "issuer."

[36] *See* section 3(a)(1)(C) of the 1940 Act. The permissible assets of the Trust suggest that it could likely meet the definition of an investment company under the 40 percent test. SB 1234 indicates that the permissible assets for the Trust are domestic equities and international equities; medium- and long-term debt obligations; U.S. government securities; real estate commingled funds that invest in publicly traded real estate securities; money market instruments, cash and U.S.-registered money market mutual funds; U.S.-registered mutual funds; insurance products; and FDIC-insured bank products. *See* section 3, title 21, 100002(e)(1)(3) of SB 1234. Depending on the allocation of the Trust assets to the listed asset classes, more than 40 percent of the Trust's total assets could easily consist of investment securities.

[37] *See* section 3(a)(1)(A) of the 1940 Act.

B. Exemptions from Regulation as an Investment Company

The 1940 Act provides for several exceptions from the definition of an "investment company," and other exemptions from the regulatory requirements.[38] While it does not appear that the Trust would qualify for any of the exemptions or exceptions, the most relevant exemptions and exceptions are generally outlined below.[39] First, section 2(b) of the 1940 Act expressly provides that the 1940 Act does not apply to any agency, authority or instrumentality of a State. The Trust, however, is not likely to qualify for that exemption insofar as the State will not accept any liability for amounts to be owed or paid under the Program.[40]

In addition, section 3(c)(11) of the 1940 Act contains express exemptions from the definition of an "investment company" for certain employee benefit plans. Specifically, section 3(c)(11) exempts stock bonus, pension or profit-sharing trusts qualified under Code section 401; certain governmental plans; bank collective trust funds consisting solely of the assets of those section 401(a) trusts, governmental plans, and certain church plans; and separate accounts the assets of which are derived solely from (1) contributions under pension or profit-sharing plans that meet the requirements of Code section 401 or the requirements for deduction of the employer's contribution under Code section 404(a)(2), (2) contributions under certain governmental plans, and (3) advances made by an insurance company in connection with the separate account's operation. The Trust does not appear to qualify for that exception. The Trust would not be a trust qualified under Code section 401; in fact, the arrangements are intended to be IRAs and would otherwise not satisfy the Code section 401 qualification requirements. In addition, the Trust would not be a governmental plan within the meaning of the exception because, among other things, the investing employees are not government employees.

C. The Regulation of Investment Companies and Their Investment Advisers

Insofar as the Trust meets the definition of an "investment company," it would be subject to federal regulations that entail two main areas of focus: substantive regulation of the activities of the investment company and requirements relating to its public disclosures. As a general matter, the

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[38] Congress also provided the SEC with express authority to exempt certain entities from the 1940 Act when, in essence, the SEC finds that it would be in the public interest to do so. *See* section 3(b)(2) of the 1940 Act.

[39] While the most relevant of those exemptions and exceptions are identified, we recommend that you consult with counsel knowledgeable with the 1940 Act regarding the availability of any of these exemptions and exceptions.

[40] *See, e.g.*, Resolution Funding Corporation (pub. avail. Oct. 20, 1989) (indicating that corporation in question could rely on section 2(b) under the 1940 Act, noting that position is further supported by the fact that the Department of Treasury is obligated to pay interest on the corporation's obligations).

applicable substantive and disclosure-based regulations would vary depending on the type of investment company that the Trust is deemed to be (*e.g.*, a mutual fund, a closed-end fund, a unit investment trust (UIT)). In our view, the Trust most closely resembles a mutual fund because it is anticipated that, among other things, eligible employees would be able to withdraw (*i.e.*, redeem) their assets at any time from the Trust, the portfolio of which is managed by a third party.[41] Mutual fund regulation requires, among other things, a board of directors that meets specified independence standards, daily valuation of portfolio holdings and satisfaction of certain investment limitations (*e.g.*, asset diversification and liquidity requirements).[42] The 1940 Act and the rules thereunder also prohibit certain interested-party transactions (*e.g.*, no self-dealing), require the establishment and maintenance of a compliance program, and regulate the manner in which assets are custodied.[43]

Many of those provisions could be problematic for the Trust, as currently contemplated. For instance, insofar as the Trust would be treated as a mutual fund, participants' interests in the Trust would have to be valued at their "net asset value," which could conflict with prescribing and paying an annually established rate of return to be set by the Board.[44] The 1940 Act regulatory regime does not contemplate such a structure. Under the 1940 Act, a mutual fund cannot sell, redeem or repurchase its securities from investors except at a price based on the current net asset value of such security that is next computed after receipt of a tender of such security for redemption.[45] Also, mutual funds cannot delay the payment of shareholder redemptions for more than seven days.[46]

[41] A mutual fund is a managed investment company that offers for sale redeemable securities. In contrast, a closed-end fund is a managed investment company that does not offer for sale redeemable securities. *See* section 5(a)(1) of the 1940 Act. Instead, the securities of a closed-end fund are generally purchased and sold on an exchange. There is no single type of UIT. One type, however, is an unmanaged trust that holds a specific set of assets for a specified period of time and is not subject to board supervision. *See generally* section 4 of the 1940 Act.

[42] In addition, section 18 of the 1940 Act provides that the securities issued by mutual funds must be voting stock, allowing mutual fund investors to vote on various matters, including the election of directors and the approval of investment advisory contracts.

[43] The investment company regulatory regime is complex, and we do not detail in this letter all of its requirements that could apply to the Trust.

[44] We also question whether any requirement for the Program that participants receive a guaranteed rate of return would implicate state insurance laws.

[45] *See* rule 22c-1 under the 1940 Act. The 1940 Act prescribes how the current net asset value would be calculated for these redeemable securities. *See* rule 2a-4 under the 1940 Act (defining "current net asset value") and section 2(a)(41) of the 1940 Act (defining "value").

[46] *See* section 22(e) of the 1940 Act.

In addition, mutual fund regulation calls for a written contract to be entered into between the investment company and the persons that are responsible for making investment decisions for the investment company.[47] Those persons would also be called upon to register with the SEC as investment advisers under the Advisers Act and would be subject to specific disclosure requirements and some substantive regulations (*e.g.*, insider trading restrictions) under the Advisers Act.[48] We understand that the Board will appoint an investment manager to manage the Trust's assets. That said, the Board's selection and/or termination of an investment adviser (the delegate) could itself trigger regulation as an investment adviser under the Advisers Act, and the Board may thereby have to register as an investment adviser.[49] In addition, the Act indicates that the Treasurer (who is to be a Board member) could invest and reinvest "[m]oneys in the program fund" that are not managed by the delegate.[50] An analysis would need to be undertaken to identify what entity would serve as the investment adviser to the Trust, and steps would need to be taken to register that entity under the Advisers Act.

Finally, the regulatory regime for investment companies would also require the Trust to take steps to register the public offer and sale of the Trust interests to be owned by the employee participants. That registration process calls for a detailed set of disclosures about the business and operations of the company.[51] The Trust would also be required to, among other things, prepare and provide to the employees semi-annual and audited annual financial reports, to disclose publicly its portfolio holdings on a periodic basis, and to disclose publicly how the proxies attached to its portfolio holdings were voted.

In sum, the Trust and the Program would need to be prepared to incur the expenses associated with compliance with investment company regulation.

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[47] *See* section 15 of the 1940 Act, which imposes substantive requirements on the terms of the written contract between an investment company and its investment adviser, and calls for, among other things, the approval of the contract by the board of directors and shareholders of the investment company.

[48] Investment advisers are required to file a Form ADV with the SEC and may be required to provide certain public disclosures to clients. Similar to the 1940 Act, the Advisers Act contains certain exemptions from the registration requirements.

[49] *See* Investment Advisers Act. Rel. No 1092 (Oct. 8, 1987). This assumes that the Board would not itself serve as the board of trustees of the Trust.

[50] *See* section 3, title 21, 100004(c) of the Act.

[51] Registration under the 1940 Act and 1933 Act involves the completion and filing of a registration statement with the SEC for review and comment by the SEC staff. Investment companies generally are required to provide their shareholders with detailed information about, among other things, the costs of investing in the company, its principal investment strategies and principal risk factors, as well as information about the investment adviser to the company.

D. Consulting with Counsel and the SEC Staff

Our comments with respect to the federal securities laws are meant to highlight issues that we believe should be considered and addressed before the launch of the Program and the Trust. In light of the 1940 Act, 1933 Act and Advisers Act concerns discussed above, we recommend that the Board consult with legal counsel knowledgeable about the regulation of pooled investment vehicles and the available exemptions from such regulation, and/or contact the staff of the SEC's Division of Investment Management (IM), which handles matters relating to the 1940 Act.

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Small employers today can select from a wide range of retirement plan options including payroll-deduction IRAs, SEP IRAs, SIMPLE IRAs, safe-harbor 401(k) plans, and traditional 401(k) plans.[52] A payroll-deduction IRA program has virtually no set-up costs beyond establishing a payroll feed. Non-profit organizations also are eligible to establish a 403(b) plan which operates similarly to a 401(k) plan, but with some important differences that can make it easier for the employer to maintain. Many financial services providers, including those based in California, offer low-cost 401(k), 403(b) and IRA-based plans to employers large and small. Furthermore, it is sometimes forgotten that generally any worker earning compensation can contribute to an IRA, and could set up an automatic payroll deduction plan if the employer's payroll system accommodates it. Retirement savings opportunities—for those who value them—are not lacking. Whether an employer chooses to make use of the many retirement plan solutions available depends in large part on the level of demand from employees.[53]

The available evidence does not indicate a compelling reason for state government entrance into this marketplace. A state-run retirement plan for private-sector employees would unfairly compete with private businesses in California. As explained above, we believe the Program will not meet the Act's prerequisites that the accounts will qualify for the favorable federal tax treatment accorded IRAs, that ERISA will not govern the arrangement, and that the Program will be self-sustaining in terms of costs. A potentially more effective approach could be to provide California state tax incentives to private employers who agree to sponsor a retirement plan for their employees. We therefore urge the Board to undertake a comprehensive examination of the true costs and benefits that would be involved in establishing and maintaining a retirement plan for private-sector employees. As with the many other states that have considered this type of proposal in recent years, the examination is likely to find that the

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[52] *See, e.g.*, "Choosing a Retirement Solution for Your Small Business," Internal Revenue Service and Department of Labor, available at www.irs.gov/pub/irs-pdf/p3998.pdf.

[53] *See* Brady and Bogdan (2013), *supra* note 4.

costs will outweigh any potential benefits. Retirement plan providers in California, including many Institute members, currently offer cost-effective solutions to employers, as well as to individuals directly through IRAs.

The Institute is available to provide additional information and clarification regarding these matters. Please do not hesitate to contact Dorothy Donohue at 202-218-3563 (ddonohue@ici.org) or David Abbey at 202-326-5920 (david.abbey@ici.org).

Sincerely,

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